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Central Intelligence Agency

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

29 November 1985

Mexico: Dim Prospects for Economic Reform [redacted] 25X1

Summary

Mexico, long touted as the model debtor, is rapidly losing its positive reputation because of government failures to take appropriate adjustment measures, and the subsequent economic problems that currently beset the country. As a result of these interrelated issues, we believe Mexico will provide a critical challenge to the international financial community and to the US Government's new initiative on debt, at least in the short-run. In our opinion, the key question for Mexico's economic future is whether President de la Madrid is able and willing to return to implementing strong macroeconomic adjustment policies and complement those with difficult, long-term economic structural reforms. In order to even begin economic adjustment, we believe the President must regain the consensus within the ruling Institutional Revolutionary Party (PRI) that allowed him to introduce tough austerity measures shortly after taking office. [redacted] 25X1

The 1986 budget--although overly ambitious and viewed as unrealistic by many inside and outside of Mexico--represents short-term movement in the right direction. However, we believe achieving even limited success in implementing this budget likely will exhaust nearly all of the President's political resources. We expect this will leave room for only piecemeal progress in removing inefficient government intervention in the economy and opening Mexican markets to foreign goods and investment. Until a comprehensive policy package combining short and long-term objectives can be put in place, either because of internal concern or external pressure, we believe Mexico will continue to risk budget overruns, current account deficits, and financing gaps which will reduce the President's latitude and increase the chances of a radical debt stance. [redacted] 25X1

This memorandum was prepared by [redacted] the Office of African and Latin American Analysis and [redacted] the Office of Global Issues. Information available as of 29 November 1985 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Mexico Branch, Middle America-Caribbean Division, [redacted] 25X1 25X1 25X1

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Initial Success Shortlived

During 1983 and 1984, Mexico's economic adjustment policies and their implementation under President de la Madrid were cited by the international financial community as the model for other debtor countries to emulate. The cornerstone of the stabilization strategy was an adjustment program supported by a three-year $3.4 billion IMF Extended Fund Facility. The objective of the program was to restore medium-term equilibrium of the economy through a combination of restrictive fiscal, monetary, and wage policies, and modifications of the exchange and interest rates. [redacted] 25X1

During 1983 and much of 1984, the adjustment program results were remarkable, according to official Mexican statistics:

- Real government outlays were reduced 20 percent in 1983 and held steady at the reduced level for the first half on 1984.
- State-negotiated work contracts--a bellwether for overall wages--cut real earnings 20 percent during 1983 and another 10 percent in 1984.
- Peso credits, in real terms, plunged one-fourth in 1983 and grew only 4 percent in 1984. 25X1
- Positive current account balances of $5.3 billion in 1983 and $4.0 billion were achieved in 1984--the first surpluses in nearly 20 years. [redacted]

As Mexico's financial troubles eased, the deep recession created by these stringent policies caused the government to reassess its economic situation in mid-1984 with an eye toward political gain. We believe the shift in policy direction that occurred reflected both Mexico City's belief that Mexicans would not accept continued strict austerity and the view that it was necessary to make a strong showing in the important July 1985 local and gubernatorial elections. We believe, on the basis of US Embassy reports, that key government officials decided a greater level of economic growth was necessary, even at the cost of higher inflation and overvaluation of the peso. According to our analysis of official Mexican statistics, high government spending along with accommodating monetary policy spurred domestic demand and significantly raised real GDP in the first six months of 1985 with real growth exceeding a 6 percent annual rate. Mainly as a result of these excesses, Mexico is now experiencing serious financial and economic problems that were complicated by the recent earthquake:

- Nearly $14 billion in budget overruns this year are being financed largely through domestic borrowing.
- The money supply has risen by 65 percent so far this year, according to Embassy reporting, fueling an inflation rate of at least 60 percent. Recent efforts to force interest rates down has nearly halted private purchases of government bonds and threatens to fuel money supply growth further.
- [redacted] capital flight is continuing at about $1 billion per month since August. This outflow has put renewed downward pres- 25X1

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sure on the peso as the free market rate has fallen from 360 per US dollar in mid-August to over 500 per dollar by late November. We believe these outflows will continue to hit Mexico's foreign exchange reserves [redacted] 25X1 25X1

[redacted]

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We believe the announcement of a new set of austerity measures shortly after the elections demonstrated the President's apparent willingness to sacrifice short-term popularity for needed economic adjustment. This commitment, however, was sidetracked by September's earthquakes which, according to the US Embassy, forced a postponement of the measures. Perhaps more importantly, de la Madrid's handling of the disaster caused latent doubts to surface among supporters inside and outside the government over his leadership ability, [redacted]

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Policy Challenges in 1986

In our view, de la Madrid will face a complex economic challenge in 1986--he needs to reduce the country's runaway public sector deficit while striking a balance which avoids a repeat of 1983's deep recession on the one hand, and resists political pressure to continue expansion on the other. On the basis of his annual budget message delivered to the Mexican Congress on 15 November, it appears de la Madrid is aware of the difficult challenge. Allowing for little or no economic growth, next year's program seeks to slash the budget deficit as a percentage of GDP in half to 5 percent and cut inflation from over 60 percent to 45 percent. The President also promised significant structural adjustments and reaffirmed the country's intention to honor its debt obligations. [redacted]

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Even though de la Madrid has demonstrated that he knows what must be done to rescue the economy, we believe he will find it increasingly difficult to follow-through on his initiatives. Despite less urgency to prime the pump for next summer's less critical elections, pressures to abandon austerity are sure to grow in the months ahead as competing interests vie for slices of a shrinking pie. For example, we expect labor will try to recoup some of the 30 percent decline in real wages suffered over the last three years, and businessmen are likely to demand compensation if increases in foreign competition threaten their profits. Meanwhile, political infighting within the President's economic cabinet threatens to undermine the confidence de la Madrid must build if he is to gain popular support, stem capital flight, and temper inflationary expectations [redacted] 25X1 25X1

[redacted] we believe the President faces a steep uphill battle in his efforts to convince Mexicans to swallow the tough medicine necessary to 25X1

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right the economy. Restoring and maintaining economic policies through adoption of sound fiscal, monetary, and pricing policies is crucial if Mexico is even to overcome its more immediate financial difficulties. 25X1

If Mexico implements these short-term macroeconomic adjustment measures, a growing number of economic observers are arguing that longer-term structural changes are needed to restore market forces, encourage domestic savings and investment, and reverse capital flight. Most of the observers believe that a combination of the following steps are necessary to counter the imbalances resulting from heavy government intervention and discrimination against private enterprise and foreign investment:

- Reducing the government's role in the economy, liquidation or sale of inefficient public enterprises and return of Mexico's banks to private sector control. This would foster private sector competition to lower prices, boost efficiency and shift the responsibility of increased production and job creation to the private sector.
- Redirecting public-sector investment to emphasize labor-intensive activities such as assembly industries, infrastructure construction, and agriculture.
- Liberalizing trade to promote competition through elimination of burdensome import licenses and bureaucratic red tape.
- Encouraging export promotion in the private sector to diversify sources of foreign exchange and reduce vulnerability to volatile oil prices.
- Changing foreign investment laws to acquire much-needed capital infusions, create jobs, and modernize Mexican industry.

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Dismal Prospects for Comprehensive Economic Restructuring

We believe prospects for implementation of longer term structural reforms are not good, since they all run counter to traditional Mexican political and economic philosophy and would have a painful impact on important interest groups. For example, government involvement in the economy has a long history in Mexico which dates back to the 1910 revolution. Indeed, many academic observers see government involvement and Mexicanization as a key legacy of the revolution and hence of the PRI. As a result, these observers conclude, and we agree, that reducing the government's role is constrained by political and cultural obstacles in addition to difficult economic tradeoffs. In a more practical vein, private sector autonomy has been sacrificed to coopt groups such as labor and the left. The government, in turn, compensates affected influential businessmen by granting them favorable treatment, such as protecting their markets and appointing them to top positions in state-owned enterprises. In addition, the US Embassy has repeatedly argued that Mexicans see the government as the engine of economic growth and the creator of jobs.

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The Mexican people also rely heavily on the government to keep goods affordable, usually at prices far below market-determined levels. Although we expect Mexico City gradually to allow prices to approach free market levels, statements by Mexican economic levels. officials show that the rationale for these actions is not based on a desire to allow market forces to prevail. Instead, the policies are seen as a means to reduce the deficit--a short-term macroeconomic adjustment rather than long-term economic restructuring. [redacted] 25X1

[redacted] 25X1 Mexico's international creditors do not anticipate government action which would be perceived as assisting the private sector, unless the growing populist sentiment within the PRI can be diffused. Because state control of the economy is such an important tool in the political process--and because public opinion gives strong legitimacy to that role--we tend to agree. [redacted] 25X1

We believe movement in this area will continue to be piecemeal at best, as long as the President is unable to instill the confidence needed to motivate Mexicans to sacrifice further toward longer-term goals. In our opinion, public investment, another tool used to coopt and influence, probably will continue to be driven by political considerations unless international lenders such as the World Bank and InterAmerican Development Bank are able to exert strong influence and redirect capital toward export-oriented and labor-intensive areas. [redacted] 25X1

On the international front, we believe strong Mexican nationalism and a longheld policy of import-substitution hinders Mexican policymakers from significantly opening the economy to foreign investment and imports. Although the decision to allow IBM 100 percent ownership--an exception to the standing 49 percent law--set a precedent, 25X1 [redacted] the move was a one-time action designed to deflect foreign critics. [redacted] 25X1

[redacted] 25X1 import liberalization is viewed with even greater trepidation. Domestic producers fear foreign competition which would threaten inefficient domestic producers who currently enjoy entrenched monopolistic positions. Since Mexico City would undoubtedly be compelled to compensate manufacturers for profits lost to foreign suppliers, at least in the short-run, in our opinion de la Madrid is not likely to make progress on this front. Mexico City's replacement of some licenses with a more efficient tariff system has helped boost imports by 30 percent this year, but we expect this policy to stall, largely because of current account problems in the face of falling oil prices and poor nonoil export performance. [redacted] 25X1

Lacking Political Consensus

Because the adjustment policies required for long-term economic health would generate powerful controversy, we believe de la Madrid will muddle through with stop and go policies which, by the end of his administration in 1988, will leave the economy in poorer shape than when he took office. Moreover, and even worse, his delays will have heightened the eventual trauma associated with an adjustment that will be more painful the longer it is postponed. From a political perspective, we believe this backsliding would aggravate existing policy conflicts within the government, strengthening the hand of those who favor more nationalistic, anti-US, and protectionist policies. [redacted] 25X1 [redacted] 25X1

[redacted] 25X1

If de la Madrid decides to attempt even partial reform, we believe the impetus for change must come from within the political establishment. The President needs to regain the consensus he commanded after taking office in December 1982 and convince the PRI leadership that it is necessary to pursue comprehensive economic reform. Nevertheless, largely because of the country's growing problems, the economic cabinet is woefully divided. If de la Madrid cannot establish unity within his own administration, the prospects for even limited reform are slim. [redacted] 25X1

Over the remaining three years of de la Madrid's term, we expect structural change to take place only where it is dictated by short-term needs. Such pressures are not only domestic in nature, but also include the need to appease international lenders who are providing aid and financing. Given the President's track record to date, however, each time headway is made in one area, he is likely to backslide in another, balancing and coopting as necessary. As he progresses down this course toward the end of his administration, we expect limited advances in subsidy reductions and import liberalization, given the recent announcement to join GATT, but little or no progress toward increasing foreign investment or significantly decreasing the government's role in the economy. [redacted] 25X1

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